SENSITIVE
10.05.2013

Section 177EA of the Income Tax Assessment Act 1936 (ITAA 1936) and "dividend washing" arrangements

Background

1. This note discusses the issues surrounding the potential application of section 177EA of the ITAA 1936 to the type of "dividend washing" arrangement described in recent national media. Particular taxpayers may enter into variations of these arrangements, and therefore a "generic" example is set out below for discussion.

2. The taxpayer holds a parcel (Parcel A) of ordinary shares in an Australian ASX listed company for at least 45 days before the ex-dividend date. The taxpayer then sells Parcel A on an ex-dividend basis.

3. Under existing ASX rules and procedures, the taxpayer is able to purchase a further parcel of ordinary shares of a similar value in the same company (Parcel B) on a cum-dividend basis during a two day "cum-dividend trading period" (being two days after the shares in the company have gone ex-dividend). The taxpayer holds Parcel B for at least 45 days.

4. The taxpayer receives the dividend (and franking credits) on Parcel A, having sold Parcel A on an ex dividend basis. The taxpayer also receives the dividend (and franking credits) on Parcel B, having acquired Parcel B on a cum-dividend basis.

5. All trades are conducted on the ASX and at the prevailing market price. The taxpayer does not enter into any derivative or other arrangements relating to either Parcel A or Parcel B.

6. The taxpayer is an entity which is able to make full use of franking benefits.

7. The taxpayer satisfies the "qualified person" rule in relation to distributions paid on each of Parcel A and Parcel B (per Division 1A of former Part IIIAA of the ITAA 1936).

Elements of section 177EA

8. Section 177EA will apply where:
   - there is a scheme for the disposition of membership interests, or an interest in membership interests, in a corporate tax entity;
   - a frankable distribution has been, or is expected to be, paid in respect of the membership interests, or has flowed indirectly, or is expected to flow indirectly, in respect of the interest in the membership interests, to a person;
   - the distribution was or is expected to be a franked distribution;
   - except for section 177EA, the person would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution;
   - having regard to the relevant circumstances of the scheme (as set out in subsection 177EA(17)), it would be concluded that the person or one of the persons who entered into or carried out the scheme did so for a purpose

(whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.

9. The first requirement of subsection 177EA(3) is that there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity: paragraph 177EA(3)(a), see also subsection 177EA(14)[1]. The relevant membership interests are the shares in Parcel A and/or Parcel B. The disposal of Parcel A would constitute such a scheme from the perspective of the taxpayer. The disposal of Parcel B would constitute such a scheme from the perspective of the vendor of those shares. Paragraph 177EA(14)(b) provides that a scheme for the disposition of membership interests includes a scheme that involves "entering into any contract, arrangement, transaction or dealing that changes or otherwise affects the legal or equitable ownership" of membership interests. It is therefore arguable (but not clear) that the disposal of Parcel B also constitutes a scheme from the perspective of the taxpayer. The stockbroker facilitating the trade may also be regarded as a person who enters into such a contract, even though they are not acquiring or selling securities in their own right but derive premium or commission income.

10. For the purposes of paragraphs 177EA(3)(b) and (c), the shares within Parcel A and Parcel B are ASX listed securities issued by large Australian corporate entities which have a history of paying, and would, by the time of these trades, have declared, franked dividends. These dividends would flow to the taxpayer in respect of those shares. It is also noted that the level of franking would be certain.

11. For the purposes of paragraph 177EA(3)(d), on the assumption that the taxpayer has passed the test for a qualified person in respect of distributions on the shares within each of Parcel A and Parcel B, they would receive, or could reasonably be expected to receive, imputation benefits in respect of their interest in those shares.

12. Finally, the application of section 177EA to the relevant scheme depends on whether, after consideration of the relevant circumstances set out in subsection 177EA(17), it would be concluded that a person who entered into or carried out the scheme did so for a more than incidental purpose of enabling the relevant taxpayer to obtain an imputation benefit.

13. Subsection 177EA(4) provides that the mere acquisition of membership interests or an interest in membership interests by a person would not of itself support the conclusion that the person did so for a purpose of obtaining an imputation benefit. There is an assumption that the person acquired the membership interests for the purpose of taking on the risks and opportunities of the ownership of the company, and that imputation benefits are a mere incident of that. The taxpayer may argue that the mere acquisition of Parcel B (and prior acquisition and holding of Parcel A) does not support any purpose of the taxpayer beyond holding a membership interest in the particular corporate tax entity.

Relevant circumstances of scheme

[1] Subsection 177EA(14) sets out matters which may give rise to a "scheme for a disposition", however the meaning of that term is not limited to or by those items.

14. Subsection 177EA(17) provides for a series of "relevant circumstances" that are to be considered in drawing any conclusion of purpose, including the eight factors listed in paragraph 177D(b). Subsection 177EA(17) does not provide an exhaustive list of all "relevant circumstances", however these matters must be addressed in determining whether the requisite purpose under subsection 177EA exists.

15. The "relevant circumstances" that may be applicable to the current arrangement are considered below. The other paragraphs of subsection 177EA(17) are either not relevant, or neither support or disprove the requisite purpose.

16. *Paragraph 177EA(17)(a):* in considering the "extent and duration of the risks of loss, and the opportunities for profit or gain from holding membership interests", the Commissioner has stated his view that the concept of "risk" for the purposes of section 177EA is broader than the delta formulation approach applied under the "qualified person" rules, and takes into account the "overall structure of the scheme:" see paragraph 15 of Taxation Determination TD 2003/32. However, taxpayers have argued that satisfaction of the "qualified person" rules, if not automatically negating the application of section 177EA, supports a finding in favour of the taxpayer in relation to this circumstance.

    The taxpayer might also argue in relation to the example scheme described above that they do not enter into any derivative or similar arrangements in relation to either Parcel A or Parcel B. If any such additional arrangements were entered into over shares within Parcel A or Parcel B, it would be a further matter to be considered in the context of whether the taxpayer's risks of loss or opportunities for gain from holding those shares were limited in extent or duration.

17. *Paragraphs 177EA(17)(b), (c), (d)*: subsection 177EA(18) sets out circumstances in which a person would be taken to derive a greater benefit from franking credits than other holders of membership interests. It has been suggested that the example scheme may facilitate the acquisition of shares (in respect of Parcel B) from non-residents who cannot make use of franking credits. Further, the consideration paid for those shares may reflect a premium for the franking credit entitlement. However, this is difficult to prove in relation to transactions conducted on-market under existing ASX rules and procedures.

    The shares in Parcels A and B comprise ASX listed securities. The issuers of those securities are not party to the arrangements relating to the acquisition and disposal of Parcels A and B. Neither the taxpayer nor the counterparty to the trades would be able to predict whether the entities issuing those shares would have otherwise retained the franking credits or paid franked distributions to other entities but for the trades.

    Guidance has been received from GAAR Panels (albeit in the context of transactions not identical to the example scheme) to the effect that the Commissioner would need to demonstrate evidence of the transfer of, or trading in, franking benefits between persons who cannot use franking credits (such as non-residents) and those who can (such as Australian residents). Where the trades

are conducted on market through the ASX, the taxpayer obtaining the relevant franking credit is unlikely to have actual knowledge of the residence and/or tax profile of the vendors.

18. *Paragraph 177EA(17)(f):* This factor looks at whether any consideration paid or given by the taxpayer in connection with the scheme was calculated by reference to the imputations benefits to be received by the taxpayer. As noted above, it has been suggested that the price paid by the taxpayer for Parcel B contains an element of premium reflecting the anticipated franking credit entitlement. This is a factual question that would need to be supported by clear evidence, particularly in relation to the very specific requirement that consideration "be calculated by reference to" imputation benefits.

19. *Paragraph 177EA(17)(i):* The period for which the taxpayer held membership interests in the corporate tax entity is also relevant. Under the scheme the taxpayer will hold each of Parcel A and Parcel B for a minimum of 45 days. It is acknowledged that the taxpayer may hold the shares for a period that is significantly longer than 45 days.

    Some taxpayers have argued that (as with paragraph 177EA(17)(a)), satisfaction of the "qualified person" rules supports a finding in favour of the taxpayer in relation to this circumstance. Nevertheless, the Commissioner is of the view that regardless of whether the taxpayer has satisfied the rules for being a "qualified person" in relation to a distribution, a short holding period is a relevant circumstance that weighs in favour of there being a more than incidental purpose of obtaining a franking benefit. This is particularly so where it can be demonstrated that the taxpayer had a predetermined strategy of buying and selling shares within a short period (rather than simply trading to take advantage of movements in the market price of the shares driven by external factors).

    However, the longer the taxpayer retains an interest in the securities beyond the minimum 45 days, the more likely it would be that this factor would be viewed in favour of the taxpayer (that is, less probative of the purpose required by section 177EA).

    It is also observed that paragraph 177EA(17)(i) only looks to the period for which (any) "membership interests … in the corporate tax entity" were held by the taxpayer, rather than the period for which particular membership interests were held. Taxpayers may argue that they have an economic interest in the corporate tax entity of a longer duration, even though there is a break in holding between parcels of shares.

20. *Paragraph 177EA(17)(j)*: This paragraph cross references the eight factors listed in paragraph 177D(b).

    Subparagraph 177D(b)(i) examines the manner in which the scheme was carried out or entered into. Taxpayers argue that the trades in Parcel A and Parcel B are intended to capture two dividends and thus generate more income/cash for the taxpayer than would arise if the taxpayer merely retained Parcel A. The shares used in these arrangements are "blue chip" securities which potentially offer high

liquidity and reliable dividend yield. Taxpayers may also take the view that such securities potentially offer lower volatility. These factors would be consistent with the taxpayers' stated strategy.

The Commissioner would emphasise that the taxpayer will also know that such securities will pay fully franked dividends, and therefore franking benefits are expected to be a significant consideration in assessing the commercial viability of the trades. The discussion by the High Court in *Mills v Commissioner of Taxation* [2012] HCA 51 (discussed further below) of the purpose of a taxpayer in entering into or carrying out a scheme is particularly relevant in this context.

Subparagraph 177D(b)(ii) compares the form and substance of the scheme. The Commissioner would highlight that the substance of the arrangement is the holding of one economic interest in the corporate tax entity, albeit with a break of up to 48 hours in that holding. This would be contrasted with the form which involves the return of two dividends and sets of imputation benefits in respect of that holding. The taxpayer would be expected to argue that the legal form of two parcels separately traded according to ASX rules and processes is consistent with the receipt of two dividends and attached franking benefits.

Subparagraph 177D(b)(iii) looks at timing and duration. Similar considerations to those discussed in relation to paragraph 177EA(17(i) arise. The time at which the scheme(s) for the trades were entered into is also relevant here; implicit in the timing of the disposal of Parcel A and acquisition of Parcel B is the intention to capture dividends and any associated franking benefits.

21. The evaluation of the "relevant circumstances" is directed to determining whether any person who entered into or carried out the scheme for the disposition of the membership interests did so for a purpose (other than an incidental purpose) of enabling the taxpayer to obtain an imputation benefit. The question here is therefore whether any person who participated in the trading of Parcel A or Parcel B did so for a purpose of enabling the taxpayer to obtain the franking benefits attaching to dividends paid on either or both of Parcel A or Parcel B.

Decision of High Court in Mills

22. The High Court confirmed that one of the objects of Part 3-6 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) is to ensure that the membership of a corporate tax entity is not "manipulated" to defeat the purposes behind the imputation system: see para [12]. Gaegler J(with whom the other judges agreed) had regard to the Supplementary Explanatory Memorandum to the Bill which introduced section 177EA, which indicated that the provision was intended as a "catch-all" that would counter "*abuse of the imputation system through schemes which circumvent the basis rules for the franking of dividends … not otherwise prevented by those basic rules*": see para [27].

23. The Court also noted at para [27] statements in the Explanatory Memorandum that section 177EA was intended to curb "dividend streaming" (being the distribution of franking credits to select shareholders) and "franking credit trading schemes" (being schemes that allowed franking credits to be inappropriately transferred).

Even prior to the *Mills* decision, taxpayers have argued that these statements in the Explanatory Memorandum evince an intention that section 177EA, an anti-avoidance provision, be limited to only those arrangements which constitute "dividend streaming" and "franking credit trading", rather than broader franking credit access or utilisation schemes which share the mischief of seeking to manipulate the imputation system. The Commissioner's response to this argument has been that the language of section 177EA does not contain any such limitations. This point was not expressly tested in *Mills*, although the High Court indicated at para [59] that a "purposive construction" of the text of paragraph 177EA(3)(e) is important.

24. The discussion of the High Court in relation to the "purpose" required under subsection 177EA(3) is of particular relevance. At para [63], the Court says that a purpose "is a consequence intended by a person to result from some action." The Court also observed that a single action may have multiple intended consequences, and it is in this context that the question of what is an "incidental" purpose arises. A purpose could be "incidental" even where it was "central to the design of a scheme if that design is directed to the achievement of another purpose": para [66]. The Court (at paras [74] and [75]) framed the section 177EA inquiry by asking whether the person had a purpose of enabling the taxpayer to obtain franking credits, and if so, was that purpose "subordinate to or in subsidiary conjunction with some other purpose." At para [67] the Court contrasted a scenario where franking of distributions facilitated a capital raising (such that any purpose relating to franking was "incidental") with a situation where the issue of equity interests was incidental to the provision of franking credits. There could also be more "nuanced" circumstances that fell within section 177EA.

25. In the present circumstances the taxpayer may seek to argue that even if they had the purpose of accessing franking credits on both parcels of shares, that purpose was subordinate to or in subsidiary conjunction with the purpose of obtaining a greater amount of income/cash through receiving two dividends. For section 177EA to apply, the Commissioner may need to demonstrate, by reference to the relevant circumstances (including those set out in subsection 177EA(17)) that obtaining the double dividend was directed to accessing the imputation benefits attaching to those dividends.

Conclusion

26. In light of the potential for a taxpayer to argue a commercial purpose in undertaking the trades which renders obtaining franking credits "incidental", and difficulties of proof in the context of on-market transactions, the Commissioner believes that he will face significant obstacles in applying section 177EA to the "dividend washing" arrangements described.